

IRS News Release

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Settlement Offer Extended for Executive Stock Option Scheme

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WASHINGTON — The Internal Revenue Service today announced a settlement initiative for executives and companies that participated in an abusive tax avoidance transaction involving the transfer of stock options or restricted stock to family controlled entities.

Under this scheme, executives, often facilitated by their corporate employers, transferred stock options to family controlled partnerships and other related entities typically created for the sole purpose of receiving the options and avoiding taxes on compensation income normally taxed to the executive. The tax objective was to defer for up to 30 years taxes on the compensation and, in many cases, resulted in the corporation deferring a legitimate deduction for the same compensation.

To date, the IRS has identified 42 corporations, many more executives and unreported income of more than \$700 million involved in this scheme.

“These transactions raise questions not only about compliance with the tax laws, but also, in some instances, about corporate governance and auditor independence,” said IRS Commissioner Mark W. Everson. “These deals were done for the personal benefit of executives, often at the expense of shareholders.”

Corporate executives who engaged in these transactions will have until May 23, 2005, to accept an IRS settlement offer to resolve their tax issues. The offer also extends to corporations that issued the options to executives and directors as part of their compensation.

Professional service firms and financial institutions aggressively promoted these abusive stock option transactions in the late 1990s and early 2000s.

The transaction first involves the transfer of stock options by the executive to a related entity, such as a family limited partnership, under terms of an agreement to defer payment to the executive. Next, the partnership exercises the options and sells the stock in the marketplace. The executive then takes the position that tax is not owed until the date of the deferred payment, typically 15 to 30 years later, although the executive has access to the partnership assets undiminished by taxes.

Tax laws require executives to include in income and pay tax on the difference between the amount they pay for the stock and its value when the option is exercised. Corporations are entitled to a deduction for the compensation when the options are exercised.

In many cases examined by the IRS, the executive's inappropriate attempt to defer tax on the compensation was paired by the corporation also deferring an otherwise legitimate tax deduction for that compensation.

Under the terms of the settlement, participating executives must report 100 percent of the compensation and must pay interest and a 10 percent penalty. This is one-half of the maximum 20 percent applicable penalty. Corporations and executives must also pay appropriate employment taxes. The parties will be allowed to deduct their out of pocket transaction costs, typically promoter and professional fees. Corporations will be allowed a deduction for the compensation expense reported by the executive.

Where corporations have been identified, the IRS will contact senior management and ask that the matter be referred to the board of directors' audit committee for appropriate review.

Finally, IRS officials believe there are a number of executives that have not come forward to disclose their involvement in transactions declared abusive in Notice 2003-47. The IRS continues to learn of these transactions through investor lists obtained in IRS promoter investigations, corporate audits and successful Department of Justice summons enforcement actions.

The IRS will continue to pursue executives and companies who participated in these transactions and do not come forward now to participate in this settlement opportunity.

"We believe a new climate under Sarbanes-Oxley, together with the tougher independence standards for auditors recently proposed by the Public Company Accounting Oversight Board make this sort of thing less likely going forward," Everson said. "However, we want to give executives and corporations a chance to clean up past transactions."

IRS Announcement 2005-19 outlines the details of the settlement offer. These details can be found at IRS.gov and will be published in Internal Revenue Bulletin 2005-11, dated March 14, 2005. The IRS also issued a Fact Sheet describing the transaction fundamentals, the troublesome corporate governance issues, and the tax and penalty costs to executives and companies who participate and those that don't.

This settlement opportunity follows the strong response to last year's Son of Boss transaction settlement initiative. Results from this compliance project, where hundreds of taxpayers came forward to resolve their issues, are in the final stages of tabulation and will be released soon.